

**PROTECTING POLICYHOLDERS FROM TERRORISM:
PRIVATE SECTOR SOLUTIONS**

Testimony

By

**J. David Cummins
Harry J. Loman Professor of Insurance and Risk Management
The Wharton School
University of Pennsylvania¹**

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Introduction

I would like to begin by thanking Subcommittee Chairman Baker, Ranking Member Kanjorski, and the other members of the Subcommittee for inviting me to testify on this important issue.

The events of September 11 have led participants in insurance and reinsurance markets to drastically reevaluate their estimates of potential insured property losses from terrorist attacks. To put the matter in perspective, current estimates are that insured property losses from the World Trade Center (WTC) attack will be at least two times as large as the largest previous insured event, Hurricane Andrew, which caused about \$19 billion in insured property losses. Hurricane Andrew resulted in the insolvency of several insurance companies and led to higher prices and reduced availability in international reinsurance markets. Over the post-Andrew years, private markets responded by supplying significant amounts of new capital to the reinsurance industry, eventually leading to reinsurance price declines and increased supply.

In my testimony, I first will briefly discuss terrorism risk in the context of risks normally handled through insurance and reinsurance markets. I will then discuss the appropriateness of a Federal role in resolving insurance and reinsurance supply problems related to terrorism. I will discuss some general principles that any Federal terrorism program should adhere to and provide a critique of the

¹J. David Cummins, The Wharton School, 3641 Locust Walk, Philadelphia, PA 19104.
Phone: 215-898-5644. Fax: 215-898-0310. Email: cummins@wharton.upenn.edu

current U.S. Treasury proposal for Federal involvement in this market.

Is Terrorism Risk Different From Other Insured Risks?

In some respects, terrorism risk is not materially different from other risks that are handled by insurance and reinsurance markets. Although the WTC attack is expected to cost at least twice as much as Hurricane Andrew, firms that model hurricane and earthquake losses have projected that losses of up to \$100 billion could result from a major Florida hurricane or California earthquake.

Questions have been raised about the feasibility of financing such a large event through insurance and reinsurance markets. A study I recently conducted indicates that the insurance industry could survive an event of that magnitude but that markets would be disrupted by numerous insurer insolvencies as well as market price and availability problems. Nevertheless, insurance industry capitalization has increased significantly since Andrew, indicating that the private market does respond to the need for coverage of large events. Moreover, events of this nature may be more efficiently handled through capital markets via financial instruments such as catastrophic risk (CAT) bonds. Securitized CAT instruments are likely to be the most efficient way to cover catastrophic events, including terrorism. *One risk of Federal involvement in the terrorism insurance market is that it would potentially discourage the development of these private market alternatives.*

Another feature of terrorism coverage that initially seems different from other catastrophic risks is its uncertainty. We have thankfully had very little experience with such events, making it difficult for insurers to estimate the probability and severity of loss. Even though we have not observed the projected \$100 billion hurricane or earthquake, we do have statistical data on hurricanes and earthquakes and scientific models exist that also can be used in gauging the expected costs of such events. Nevertheless, the insurance industry has provided coverage for other uncertain events which lacked statistical reliability such as political risk insurance and satellite launches. It is likely that the private market can eventually develop pricing for terrorism coverage as it has for other uncertain and unique risks. *Therefore, any Federal involvement should be done in such a way as to not discourage private industry from returning to this market.*

Appropriateness of a Federal Role

Terrorism insurance and reinsurance have become generally unavailable following September 11. The unavailability of insurance causes severe economic problems for policyholders, including difficulties in financing construction and investments in other new projects, potentially having a damaging effect on the economy. Given that most reinsurance contracts will be up for renewal over the next few weeks, a Federal role may be appropriate in getting the industry and the economy through the current crisis. However, any Federal involvement should be done in such a way as to encourage private market “crowding out” of Federal insurance or reinsurance. Federal insurance or reinsurance should be priced in such a way as to eventually make it attractive for private firms to return to the market and undercut government pricing. There should be a clear “sunset” date when the program would have to be renewed or allowed to expire.

General Principles of a Federal Program

A. The objective of the Federal program should be clearly stated as: (1) Helping policyholders and insurers to weather the current crisis, and (2) encouraging private insurers to return to the market and eventually replace government coverage.

B. The Federal program should avoid the creation of new private or public institutions and any new bureaucracies, which are likely to be difficult to eliminate. Rather the program should be run through existing Federal agencies such as the Department of the Treasury. One appropriate design would be the periodic sale or auction of Federally backed excess of loss (XOL) reinsurance contracts.

C. Federal XOL contracts should be sold at a price no less than the best available estimate of the expected losses and expenses likely to arise under the contracts, with a risk loading of some multiple of the expected loss such as 100 or 200 percent. Loadings of this magnitude are common in the reinsurance market for high level XOL contracts, and such loadings would be considerably less than the median loading in the CAT bond market. An actuarial firm should be retained to price the contracts with the objective of trying to determine a price that is in the range that would likely be charged by private insurers or reinsurers. The objective of pricing the contracts in this way would be to provide appropriate incentives for policyholders, insurers, and reinsurers not to misuse the contracts and to encourage private firms to reenter the market to compete with the government contracts. The possibility of securitizing a proportion of the coverage should be explored to facilitate price discovery.

D. Any Federal XOL coverage should have a cost sharing provision, i.e., the government should not cover 100 percent of any layer of coverage. An appropriate co-payment provision could be established whereby the government would be responsible for, say, 70 percent of the loss and the private insurers and reinsurers responsible for 30 percent. The purpose of this provision would be to provide the incentive for insurers and reinsurers to settle claims conservatively and appropriately in the government layer of coverage and to obviate the need for a Federal bureaucracy to oversee claims settlement. Failure to deal adequately with potential claims settlement incentive problems could expose the government and taxpayers to substantial liabilities that would do little to benefit the overall health of the economy.

E. Federal coverage should start after a reasonably large deductible, i.e., the government should not provide first dollar coverage. This is based on the principle that all parties to a contract should share in the risks at every layer of coverage. This approach also parallels private XOL reinsurance markets, where first dollar coverage is unavailable. The deductible should be adjusted upward over time to reflect private market capacity.

F. The Federal obligation should be capped. For example, government coverage should stop at some

reasonable limit such as \$60 billion, \$75 billion, or \$100 billion. This is to protect taxpayers from an open-ended commitment. A cap provides Congress with a valuable option – either to reinstate coverage for losses above the cap or to terminate government involvement at the cap.

G. The program should be limited to property coverage, where loss amounts are relatively easy to determine. The Federal program should not provide coverage for difficult to verify claims such as business interruption. This is to prevent abuse of the Federal program and to provide incentives for policyholders to get back in business as quickly as possible following a loss. Avoiding coverage for business interruption also provides incentives for businesses to adopt strategies that would minimize and mitigate losses to revenues following a terrorist attack. The program should not cover liability insurance, for similar reasons, including punitive damage awards.

H. Consideration should be given to incorporating “Finite Reinsurance” provisions into any Federal plan. Finite reinsurance transfers less risk to the reinsurer than traditional indemnity reinsurance. It is primarily intended to smooth out an insurer’s losses over time, with the insurer ultimately bearing most of its own losses. Essentially, the finite reinsurer advances the insurer money when losses are high with the contractual obligation for the insurer to pay back most of the money when losses are relatively low. Although some indemnity-only features may be appropriate in higher layers of Federal terrorism insurance, the plan might be more appropriately written as finite reinsurance, especially for relatively low layers of coverage.

I. The government should explore ways in which it could encourage the development of private markets for catastrophic risk without providing Federal financial backing. For example, it should investigate the possibility of lowering regulatory barriers that may exist to securitizing insurance risk and taking control of this aspect of insurance regulation to simplify the regulatory system. The government should also explore serving as a facilitator of securitization by providing data that could be used by private firms in developing better loss indices to serve as the basis for the trading and settlement of CAT risk securities, on both natural and man-made (e.g., terrorism) catastrophes.

The Treasury Proposal

The proposal I am discussing is the “Background Briefing by Senior Administration Officials on Terrorism Insurance,” Office of the Press Secretary, The White House, October 15, 2001.

The proposal calls for Federal terrorism coverage with loss sharing between the Federal government and the private insurance industry. It states as follows:

Individuals, businesses, and other entities . . . would continue to obtain their coverage from private insurers. . . . If there is a future terrorist act, losses . . . from that terrorist act would be filed with the insurance company. The insurance company would pay their portion of the loss . . . Then they would file their balance of the claim with . . . the Department of Treasury . . . and then the Secretary of Treasury would pay the balance of the policy coverage.

The proposed sharing ratios, which vary by the year of the program, are as follows:

First year: First dollar coverage is provided with the government paying 80% and the insurers 20% up to a limit of \$20 billion. For losses above \$20 billion, the government would pay 90% and the industry 10%.

Second year: For the first \$10 billion, the private insurance industry would bear 100%. Losses above \$10 billion would be split 50% for the government, 50% for private insurers. If losses exceed \$20 billion, the ratio would go to 90% for the government and 10% for private industry.

Third year: Private sector would be responsible for 100% of the first \$20 billion. From \$20 to \$40 billion, the loss sharing would be 50:50, and for losses above 40 billion, the government would pay 90% and private industry 10%.

There would be a proposed overall cap of \$100 billion. If total losses paid by industry and the government reached \$100 billion, the Secretary of Treasury would request guidance from Congress as to how any larger losses should be paid.

The plan would sunset after three years. There would be some loss mitigation provisions and a prohibition on punitive damages coverage.

Comments on the Proposal

The proposal incorporates several sensible provisions such as cost sharing (for most layers of coverage) and an overall cap on the government's obligations. The loss mitigation proposals are a good idea in general but no specifics are given. The sunset provision is strong point of the proposal.

Problems with the proposal:

1. It may be neither necessary nor advisable to provide first dollar coverage during the first year. The private industry should sustain the first layer of coverage. This provides appropriate incentives for loss mitigation and claims settlement conservatism and gives private insurers a stronger stake in loss outcomes. The industry should be able to sustain a loss of \$10 billion, and probably more, without government involvement. The industry's involvement in covering the first layer would be an act of good faith and a signal of commitment to the economy.
2. Without considering each year and layer case by case, the proposal generally is too generous in its split between the government share and the industry share. The industry should probably bear more of the cost, especially in the lower layers.
3. The reinsurance in the lower layers of coverage should be written as "finite reinsurance" rather than pure indemnity reinsurance as in the present plan.

4. The plan apparently covers all risks, with the exception of punitive damages. There are many types of risks that should not be covered by Federal insurance/reinsurance, such as business interruption and liability insurance, as discussed above.

5. There is no provision for charging private industry a premium for the coverage. This is a very serious defect which creates adverse incentives and discourages private insurers from reentering the market. It is difficult to compete with a product that is given away for free. Even though any premium estimate would be inevitably somewhat inaccurate, this is also the case with many other unique and uncertain risks covered by insurance.